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ZNR UUUUU ZZH

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FM AMEMBASSY MEXICO

TO RUEHC/SECSTATE WASHDC PRIORITY 8381

INFO RUEHXC/ALL US CONSULATES IN MEXICO COLLECTIVE PRIORITY

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UNCLAS SECTION 01 OF 03 MEXICO 004282

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TREASURY FOR IA (ALICE FAIBISHENKO)

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SUBJECT: MEXICO'S MAQUILAS CLAIM NEW TAX COULD KILL
INDUSTRY - BUT THE REAL PROBLEM IS PAYROLL TAXES

REF: A. MEXICO 3246

[1B](#). MEXICO 3859

[1C](#). MEXICO 4151

[1D](#). MEXICO 4191

[1E](#). MEXICO 4236

[1F](#). MEXICO 4280

Summary and Introduction

[11](#). (U) Summary: Econoff spoke with representatives from the National Council for the Maquiladora Export Industry (CNIME) August 7 regarding the effects the new Single Rate Business Tax (CETU) will have on the industry. The President, Jose Jesus de Calleros, said that CNIME supports the concept of the tax, but the way it is currently planned could kill the industry as it is a huge increase and eats up profits. The main concern is that labor cost deductions are not allowed. While, even with some of the discussed changes, the tax will lead to an increase in taxes for the industry, it is unlikely that the CETU will lead to the end of maquiladoras in Mexico.

End Summary.

CNIME Supports CETU, BUT...

[12](#). (U) CNMIE President Calleros stressed that the industry does not oppose the CETU and they understand that reform is necessary, particularly in light of declining oil reserves. He said that CNIME wanted to suggest modifications that would make the CETU work. Specifically, he said that maquilas already pay taxes and do not want to pay more than they already do. He said that the administration presented the CETU too hastily and without proper research into its effects. The Director of CNIME's Fiscal Committee, Ignacio Valdes, explained that the CETU is a tax on production, and since the maquila industry accounts for 40 percent of the country's production, they are most acutely affected. Additionally, he said that not only do maquilas pay taxes as a company, they pay employees who, in turn, pay Value Added Tax when they purchase goods.

A Maquila Tax Primer

¶3. (U) By law, maquilas have a minimum profit level of between 6.5 and 6.9 percent for tax purposes. They are then taxed 28 percent on their profits. Earlier this decade, to keep the maquila industry from losing business to China, President Fox issued a decree halving the tax rate to 14 percent of profits. For example, using round numbers in USD for simplicity,

Income =	106.5 USD
Costs =	100 USD
Profit =	6.5 USD
Tax Rate =	28 percent
Decree Tax Rate =	14 percent
Actual Taxes Paid =	91 US cents

While the rate is 14 percent of profit, it is less than 1 percent of income.

¶4. (U) The CETU in comparison, bases the tax on income and not profit. The maquila industry is labor intensive with the majority of its costs going to labor. The CETU currently does not allow deductions for labor costs although it does provide credit for income tax withheld. Using the same maquila from the example above,

Income =	106.5 USD
Deductible Costs =	30 USD
Tax Base =	76.5 USD
Tax Rate =	19 percent
Tax =	14.53 USD
Paid by company =	8.65 USD

According to the figures provided by CNIME the company in the example above will pay 850 percent more in taxes.

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CETU Hurts What It Is Supposed to Help

¶5. (U) CNIME highlighted the danger the CETU poses to the two main areas the Government of Mexico (GOM) is trying to promote: investments and job creation. Industry representatives feel that if the CETU is implemented without changes, investors will shift funds to countries with a more competitive tax structure. Calleros said that other countries have studied and learned from Mexico's maquila industry and provide a viable alternative if the GOM implements the CETU. Calleros also worried that the CETU would stifle job creation, essential to increasing Mexican growth.

¶6. (U) CNIME maintains that anything that threatens the maquila industry threatens competitiveness and the overall well being of the economy. Valdes noted that the maquila industry stimulates consumption by paying workers who, in turn, consume. Maquilas employ 1.6 million directly and create another 5 million jobs indirectly. Forty percent of participants in the Mexican social security system are involved in the maquila sector.

CNIME's Objections

¶7. (U) CNIME's main objection to the CETU is the lack of deductions, particularly for the various labor and social service costs maquilas pay. A large part of the maquila industry is labor intensive and the payments to employees' pension and housing plans constitute 70 percent of business costs. Under the CETU, salary costs and housing and social security fund contributions are not deductible. Jesus de Calleros said that, it is contradictory for Mexico, trying to promote job creation, to penalize companies that hire more employees.

¶8. (U) The CETU also eliminates key benefits that the maquila industry currently enjoys such as a 50 percent discount on taxes and stimulus for research and development. The CETU also does not allow deductions for the temporary export of goods. According to CNIME, removing these deductions would eliminate the main draw for companies to Mexico's maquila sector. Additionally, companies that also do business in the United States and other countries that do not recognize the CETU for reciprocal taxation purposes, would be doubly taxed, further decreasing Mexico's competitive edge.

GOM Disagrees

¶9. (U) CNIME complains that, even though the Secretariat of Finance (Hacienda) maintains that the tax is meant to target tax evaders and those who structure their books so they pay no taxes, maquilas, taxes will increase between 500 and 800 percent. CNIME and Hacienda disagree on the effect the tax will have on the industry. According to CNIME, Hacienda based its figures on broad macro economic data which does not show the true effect on companies because it does not take into account the different expense structures of firms in different sectors and with different numbers of employees. They will be working with Hacienda over the coming weeks to discuss the numerical data.

CNIME Will Continue Fight

¶10. (U) Valdes said extra revenue raised by the CETU does not warrant risking jobs and future investment. He argued that the additional money that the government intends to collect from companies that are already paying taxes would be better left in the private sector where the money could be used to continue investments and create more jobs. The alternative would be to overtax companies, leading them to invest less and create fewer jobs, which in turn would increase the demand for government social programs putting more pressure on government finances.

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¶11. (U) Jesus de Calleros reiterated that the CETU does not need to be eliminated, only modified so that it does not hurt competitiveness. He said that CNIME had been in continual contact with members of the relevant committees of the Mexican Senate and Chamber of Deputies to work out changes that would help the maquila industry. He stressed that the maquila program had survived for 40 years and had generated technology advances, employment and economic growth which would all be under threat if the CETU were approved without considering the maquila industry.

Comment

¶12. (SBU) If the figures provided by CNIME are correct, many maquila companies will pay more in taxes than they make in profits. The GOM must increase tax collection, however, and any concessions granted to the maquila industry would lead to demands for concessions from other industries. The best solution would be a labor reform that decreases the large amount of money companies must pay for the wide array of government "social security" type payments regardless of whether their employees benefit from the government programs being funded. Such mandatory payroll expenses include payments for housing, daycare, pensions, health care and holiday bonuses. Since the amount firms must pay is tied to their number of workers, labor-intensive industries would be hurt if they can no longer deduct such fees from their overall taxes. These long-standing payroll taxes help support Mexico's social welfare bureaucracy, and are viewed (at least politically) as providing a social safety net for those workers employed in the formal economy.

¶13. (SBU) It is unlikely the situation is as dire as CNIME paints it. Companies with long histories in Mexico will do as much as possible to avoid beginning anew in another country. We believe investors would also be willing to give up some profit if they believed it meant an overall increase to Mexico's competitiveness and future higher returns. Most investors in Mexico agree on the urgent need to increase tax collections in Mexico, but would rather the large informal economy and other tax evaders be taxed rather than only raising taxes on those companies that are registered in the formal economy and already paying some taxes. The Mexican Congress is considering reducing the CETU rate by 3 percent or allowing certain additional deductions, which would be the most likely remedies for the maquila industry. That being said, if the CETU is passed in any meaningful form, the industry will have to accept that they will be contributing more to the Mexican coffers than in the past. End Comment

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